Docket No. 18-72451

In the

United States Court of Appeals

for the

Ninth Circuit

CELIA MAZZEI, et al.

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeal from the United States Tax Court
Case Nos. 16702-09 and 16779-09
Hon. Michael B. Thornton for the Majority of the Tax Court

REPLY BRIEF FOR APPELLANTS

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"OVERCONTRIBUTION": WHY IT DOESN'T WORK ON THESE FACTS

This entire case comes down to a single word: *overcontribution.* Without that, there is no excise tax, and there is no issue. Having repeatedly tried and failed to find a way to get there in the utterly unique context of Roth IRA ownership of export-subsidizing entities, the Commissioner tried one final frontal attack relying upon the substance over form principal. The Tax Court declined to follow the Commissioner's lead, and instead shape-shifted around prior reversals by shaming the ownership of FSC stock—rather than the cash flow between the FSC, the related exporter, and the Roth IRA—all in service of the same end result: *overcontribution.*

Why does this latest effort fail? The Commissioner's own brief admits that:

1. Congress has long known about Roth IRA ownership of FSCs. (Br.7-8).[1]
2. But Congress has—to this day—done nothing. "To be sure, Congress to date has not enacted a categorical prohibition on the scheme." (Br.35).
3. The IRS has lost all of its other substance over form attacks on the same structure. (Br.38).

As demonstrated below, there is nothing distinguishable, let alone novel, about what the Tax Court did here—or what the Commissioner is arguing in an

[1] Hereinafter, Respondent's Brief will be referred to as "Br." plus page number.

attempt to save an untenable result. Far from it, the Mazzeis are merely the latest in the Commissioner's thus far unsuccessful attempts to use the substance over form principal to leapfrog over express Congressional mandate to reach the desired conclusion of *overcontribution.*

IF AT FIRST YOU DON'T SUCCEED: HOW WE GOT HERE

"One such enforcement effort, however, was rejected at the appellate level." Br.8

Indeed! Respondent's attempt to disregard DISC/FSC-Roth IRA transactions was rejected by three Circuits and, on two memorable occasions, by the Tax Court itself.[2]

Because FSCs and DISCs can create tax savings, the Commissioner has long attempted, with little success, to uproot some of their transactions. As far back as 1978, the Court of Claims held that DISCs and Western Hemisphere Trade Corporations could create multiple tax benefits to a shareholder utilizing each regime for a product sale: "The Commissioner cannot fault taxpayers for making the most of tax-minimizing opportunities Congress created." (*Caterpillar Tractor Co. v. U.S.*, 218 Ct. Cl. 517, 526-528 (1978)).

Enter Roth IRAs, where tax advantages in a retirement plan could increase those in a DISC or FSC, and the Commissioner intensified his attacks. In *Hellweg*

[2] Because DISCs and FSCs are treated the same for excise tax purposes (ER169:87), the DISC cases cited *infra* are controlling here as well.

v. Commissioner, where DISC stock was purchased by the taxpayers' Roth IRAs, the Commissioner tried to unwind the transaction through a now-familiar fiction: using substance-over-form, he determined that the transaction lacked substance, and he redirected the Roth IRAs' DISC commissions to the taxpayers—who then supposedly "overcontributed" those commissions to their Roth IRAs, resulting in excise tax liability. (*Hellweg v. Commissioner,* T.C. Memo 2011-58). But the Tax Court held that the Commissioner could not challenge the substance of the transaction for income tax purposes, because to do so would require the substance of the DISC to be disregarded, and that in turn would frustrate Congressional intent behind the creation of DISCs. (*Id*., at *9). Without an income tax adjustment there could be no overcontribution to an IRA, and hence no excise tax. (Id., at *24-25).

The Commissioner tried again, in *Ohsman v. Commissioner,* T.C. Memo 2011-98, an FSC case where Judge Nims rejected the Commissioner's reliance on Notice 2004-8 and held that because Section 4973 of the Code is "intertwined with and inseparable from the income tax regime," the Commissioner "cannot rely on the substance-over-form doctrine to recharacterize the Transaction for purposes of section 4973 only." (*Id*., *6).

Continuing a trial and error approach, the Commissioner next sought Notice 2004-8 enforcement against a transaction entered into by the two Benenson brothers, whose Roth IRAs purchased shares of a newly formed DISC and received

substantial dividends. Again, the Commissioner argued substance-over-form: "he reasoned that the effect of these transactions was to evade the contribution limits on Roth IRAs and applied the 'substance-over-form doctrine'… to recharacterize the transactions …" (*Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779, 781-782 (Sixth Cir. 2017)). Dividends from Summa Holdings were, the Commissioner argued, really the property of the Benensons, who then 'over-contributed' them to their Roth IRAs. The Tax Court held for the Commissioner, and was reversed by the Sixth Circuit in Circuit Judge Sutton's lucid opinion. (Id.). The First and Second Circuits agreed, and they also reversed the Tax Court.

By this time, the Commissioner had lost twice in the Tax Court, and his three wins in the Tax Court were short-lived: all were promptly overturned by three different Courts of Appeals. Five losses for the Commissioner, all on the issue of whether a taxpayer's Roth IRA really could hold stock in a DISC or FSC without suffering multitudinous nasties at the hands of the Commissioner, in each one of which the Commissioner relied upon variations of the same legal arguments in order to find *overcontribution*.

The Commissioner's trial and error approach to reach *overcontribution* had failed—spectacularly. And then came the *Mazzeis*.

Mazzei was tried to a judge who, prior to taking the Tax Court bench, had worked at the International Trade Commission, was personally familiar with the

history of FSCs, and who thought the transaction worked—after hearing all the evidence. But the Tax Court removed the case from him, deciding *en banc* that it did not. (ER156:167/3-25 & 168/1-5).

Stymied by *Summa*, the Commissioner tried one last frontal assault on the transaction. But the Tax Court, presumably wary of another reversal, purported to take a "narrower" approach, and honed a new theory to reach the exact same result—evisceration of FSC stock ownership by the Mazzeis' Roth IRAs, and redirection of FSC dividend income to the Mazzeis. Instead of applying substance-over-form to the entire transaction – an approach thrice rejected on appeal – the Court affected a "narrower factual basis" in which FSC stock *ownership* was called into question. By this judicial alchemy, the transaction—factually identical to *Summa*—magically became, yet again, an *overcontribution.*

At this point, it is useful to identify what the issue herein really is. The "question" is not, as the Commissioner disingenuously urges, whether the Tax Court "correctly applied the substance-over-form doctrine to treat funds *shifted* to the Roth IRAs as distributions from the FSC to appellants, followed by excess contributions to the Roth IRAs." (Br. 1, emph. suppl.). *That* is the very position rejected in *Summa* and *Benenson*, where the Commissioner attempted to "shift" funds to the taxpayers. In *Mazzei*, the Tax Court – well aware of its recent reversal—"shifted" stock instead of funds, with the exact same *overcontribution*

result. Finding no precedent on point, the Tax Court cited an array of sales and leaseback cases for the proposition that there was something inherently defective in how, exactly, the Mazzei Roth IRAs purchased and held their FSC stock.

The real "question" before this court is whether the Tax Court erred in reassigning ownership of stock in an FSC that met all Code provisions, simply because the entity that purchased its stock (for a price consistent with then-prevailing standards) was also tax advantaged.

Appellants submit the answer is Yes. The decision below is fundamentally wrong. It seeks to overturn a transaction factually the same as transactions already upheld by three circuits. As more fully argued in Appellants' Opening Brief, those decisions should be accorded comity herein. In contrast, the Commissioner relies on general corporate and sale/leaseback cases inappropriate to the unique characteristics inherent in a Foreign Sales Corporation.

DISCUSSION

1. Factually, Mazzei And Summa/Benenson *Are* The Same Issue

The Commissioner argues that while *Summa* and *Benenson* involved Roth IRA stock ownership, they are not the same as *Mazzei* because, following its reversal by the Sixth Circuit, the Tax Court came up with a new theory to accomplish the same result. But the facts *are* identical: in both cases, stock in a DISC or FSC was purchased by Roth IRAs belonging to persons interested in the

underlying business. In *Summa* and *Benenson* the transactions were upheld. In the proceedings below, it was agreed that for excise tax purposes, DISCs and FSCs are treated the same. (ER169:87). Thus the factual issues are the same. The "difference" is that the goal posts have been shifted.

The Tax Court does not like the result when, like numerous other taxpayers,[3] the Mazzeis' Roth IRAs purchased stock in an FSC designed to stimulate foreign trade. Nor does the Commissioner. In his brief he repeatedly employs the term "scheme" – four times on page 2 alone and fifteen additional times on following pages (including two footnotes), until one wearies of keeping count. But pejorative appellations are not persuasive legal argument – nor are sale and leaseback cases, far outside their factual and legal construct.

As used by the Commissioner, "substance over form" is a catch-all panacea to legitimate a result already rejected in factually identical cases. The cases relied upon by the Commissioner are predominately those where property was owned by someone who tried to transfer ownership in a manner that left them in effective control. This is utterly different from *Mazzei*, where a Congressionally-created shell corporation had no history of owning anything. The Mazzeis respectfully

[3] Notice 2004-8 reveals that transactions such as WGA's Small FSC program were widely used. Following the Commissioner's losses in *Summa* and *Benenson*, *Mazzei* became the test case.

submit that the Commissioner's arguments are misplaced authority searching for a home.

2. <u>Congressional Intent Should Be Persuasive</u>

"Nothing in the FSC provisions suggests that Congress intended to provide an exemption from the Code's Roth IRA limits." (Br.66) Nothing, that is, except Congressional knowledge of exactly what the taxpayers did in *Summa*, *Benenson*, and *Mazzei*, after which Congress did nothing to change it – an important factor in the Ninth Circuit's *Taproot* case.

Where Congress has created a "congressionally innovated corporation" (*Summa*, 848 F.3d at 782) to accomplish a public policy goal, Congressional intent should strongly influence a Court's decision. (*Chevron v. NRDC, Inc.* 467 U.S. 837 (1984)). The case herein turns on two Congressionally-created entities, FSCs and Roth IRAs, each intentionally providing tax advantages. When used together, tax benefits increased – a factor of which Congress was clearly aware. "We assume Congress is aware of existing law when it passes legislation." (*Miles v. Apex Marine*, 498 U.S. 19, 32 (1990)). Citing a Joint Committee Report, the Commissioner *admits* that "Congress is aware of … abusive Roth transactions." (Br.7) But being aware, Congress to this day has done nothing to stop what the Commissioner (mis)characterizes as "abusive."

The Commissioner argues that while Congress may have intended the FSC's tax advantages, there is no indication these extended to a Roth IRA stockholder. *But not so fast:* to accomplish its goal of promoting foreign sales of U.S. goods, Congress employed tax incentives and allowed related party ownership of FSC stock to ensure that those incentives were realized. (Treas. Reg. § 1.922). But the *type* of entity that owned FSC stock also impacted the tax result. For example, in *Mazzei,* the exporter was Mazzei Injector Company, an LLC which contracted with the FSC. (ER156:10). Distributions of FSC income to a non-corporate shareholder such as an LLC would be taxable in full, with no foreign tax credit. (BNA Portfolio Export Tax Incentives, 934-2d, at A-60-61; see b. on p. 61). Making Mazzei Injector Company the owner, under a benefits and liabilities analysis, would have been totally counter-productive to Congressional intent.

Going one step further, if FSC stock were sold on the open market and owned by a third party, whose management decisions did not provide tax advantages to the exporter, the Congressional purpose would also fail.

Thus, FSC stock was foreseeably owned by an interested party. Could that interested stockholder be the taxpayer's Roth IRA? The Commissioner says "No"—without any citation to authority—arguing instead that there is nothing in the legislative history protecting Roth IRA ownership. But he misses two important points, found in citations he offers:

1. He cites Joint Committee Reports (Br.7) in which he assures the Court that "Congress is aware" of the problem he complains of.
2. He cites *Taproot v. Commissioner* – but therein the Ninth Circuit found that Congressional inaction conveys Congressional intent.

Both citations backfire. If there were a "problem" of which Congress was aware, why didn't they fix it? Joint Committee Report JCS-1-08, cited by the Commissioner, was issued in 2008 – eleven years after Roth IRAs were created, and *twenty-four* years after the creation of FSCs. Congress, fully "aware," had—and still has—done nothing to correct a supposed "abuse." And in *Taproot*, the Ninth Circuit recognizes that Congressional inaction can demonstrate Congressional intent.

In *Taproot*, the issue was whether a Roth IRA could own subchapter S stock, and "no statute or regulation [then] in effect … explicitly prohibited" such ownership. (*Taproot Admin. Servs. v. Comm'r*, 679 F.3d 1109, 1113 (9th Cir. 2012)). Seeking guidance from legislative intent, the Court noted that when Congress initially drafted the S corporation statute, Roth IRAs had not yet been created. (Id., 1114). Employing a tool useful herein, the Court reasoned that "had Congress intended to render IRAs eligible S corporation shareholders, it could have done so explicitly." (Id.) In other words, Congressional inaction was used to discern Congressional intent. The "only available evidence" of Congressional

intent was the fact that nothing had been done: "If at any point Congress had intended IRA eligibility it could have amended the statute." (Id., 1118). Based on legislative intent inferred from Congressional inaction, the Court found against the taxpayer.

But what about *Mazzei,* and Congressional inaction here?

In *Mazzei,* the same issue appears in reverse: here, Congress was also "aware" of the issues. Individual Retirement Accounts were created by Congress in 1974 as part of the Employee Retirement Income Security Act. Roth IRAs were created as part of the Taxpayer Relief Act of 1977. Both DISCs and IRAs have co-existed side by side since 1974, and Roth IRAs existed alongside FSCs, during the entirety of their existence, throughout which the Commissioner bitterly disputed IRA ownership of DISC or FSC stock, in *Swanson v. Commissioner,* 106 T.C. 76 (1996); *Ohsman, supra; Hellweg, supra.*

Congress was "aware," yet Congress did nothing when, in 1997, it enacted Section 408A, establishing Roth IRAs—even though a simple amendment to section 408 could have accomplished the goal of stopping what the Commissioner seeks to unwind by reassigning stock. *To this date, Congress has still taken no action on Roth IRA ownership of FSCs or their progeny.*

Making the best of a bad argument, the Commissioner claims that Congress has knowingly stood down, preferring to let the Commissioner fight this war

(Br.34-35). An odd assertion, to be sure, because thus far he has lost each battle. More persuasive is the Ninth Circuit's guidance in *Taproot.* Appellants urge that Congress knew about and chose not to prohibit the transactions twice allowed by Judge Nims on the Tax Court, and upheld by the First, Second, and Sixth Circuits.[4]

The Commissioner's citation to *Samueli* deserves brief rebuttal. Therein the Ninth Circuit determined that a purported securities loan, "entered into not for the purpose of providing the borrower with access to the lent securities" failed to meet the Congressional purpose for nonrecognition of income. (*Samueli v. Comm'r.*, 661 F.3d 399 (9th Cir. 2011)). Therein this Circuit relied on an *explicit Congressional goal* which the Taxpayers had avoided (Id., at 412). But herein, Congressional intent is determined by using this Circuit's *Taproot* rule: Congress knew about Roth IRA ownership of FSCs and did not act.

Finally, the Commissioner and the Tax Court ignore the fact that the Roth IRAs were the parties under contract and were the legal owners of the FSC. In arbitrarily reassigning stock ownership, the Commissioner substitutes parties not contractually involved in the relationship. There is no Treasury Regulation authorizing him to do so. This is a classic case of textual avoidance by the Commissioner.

[4] The Tax Court's inapt holdings on the viability of Roth IRA transactions outside of the FSC context have nothing to do with the issue in this case. While there are undoubtedly abusive Roth IRA transactions, none of the other cases required the courts to sham the structure created by Congress.

3. The Commissioner's Stock Ownership Analyses Are Flawed

On his journey through an archipelago of legal theories, the Commissioner's misplaced departure point is a failure to recognize that the open market stock issues he cites – such as risk-benefit, economic reality, supposed improper "control" of the FSC transactions, and return on investment – are all anathema to the transactional structure Congress established when it created Foreign Sales Corporations. An FSC never was, nor could it ever be, a publicly traded commodity; its stock was inherently *not* designed for sale on the open market.

To do so would have been to unwind the very incentives Congress built into the program. FSCs were designed to stimulate foreign sales of U.S. goods, and FSC shares served both a narrow purpose and a narrow market, in which the exporter was incentivized through ownership of the FSC shares – either by him/her or by an entity owned by him/her. This is the issue the *Summa* and *Benenson* courts recognized, and which the Commissioner and the Tax Court seek to avoid.

As a result, FSC's were quite naturally owned by interested parties, with predictable features such as attractive stock pricing and related party control of the transactions into which the FSC entered. Congress was not only aware of this, the Regulations allowed it, and the Mazzeis faithfully complied with the Code and Regulations. (ER169:93).

And, yes, some FSC participants had Roth IRA retirement plans. That Congress was aware of this is ably illustrated by the Joint Committee Reports the Commissioner cites.

In each of the issues raised by the Commissioner, he fails to recognize that the theories he asserts, under the general rubric of substance-over-form, are drawn from general corporate and contract law, and not from the unique corporate structure in which the very characteristics of which the Commissioner complains were predictable and present; to sham those elements of the statutory scheme is to sham Congressional intent.

The Commissioner thus mistakenly treats FSC shares as if they were routinely bought and sold in a market where tests such as risk and benefit might be employed to determine stock ownership. Lacking authority on point, he analogizes unrelated cases such as *Brown v. United States* (Br.46) which, like the Commissioner's other authority, are factually inapposite. *Brown* was an estate planning case devoid of the unique relationship between a FSC and its owner(s).

A. <u>The Commissioner's Risk-Benefit Analyses Are Misplaced</u>

The Commissioner misuses general corporate cases to sham the Mazzei Roth IRA stock ownership, and thus mis-cites risk-benefit decisions which do not apply to stock that was never designed for sale on the open market. Mazzeis will

not respond to each, but will illustrate the Commissioner's fallacy by reviewing four.

Solberger, cited for the proposition that FSC stock cannot be owned by someone who doesn't have "funds at risk," (Br.51), *didn't even involve a stock purchase*. It was, instead, a failed lease transaction in which the taxpayer never acquired a leasehold interest and hence was not entitled to a rent deduction. The taxpayer also purported to transfer $1 million worth of floating rate notes in exchange for a nonrecourse loan, which the lender apparently never expected to be paid. (*Solberger v. Comm'r*, 691 F.3d 1119 (9th Cir., 2012)). Naturally, this Court denied a rent deduction and held this to be a taxable sale of the FRNs. But how does that apply to stock in an FSC, purchased by a foreseeably related party? It does not.

Similarly, *BB&T* is cited for the proposition that the taxpayer must have "funds at risk." (Br.51). But therein the factual issue was "a circular transfer of funds" which was really "a financing arrangement, not a genuine lease and sublease." (*BB&T Corp. v. U.S.*, 523 F.3d 461, 475 (4th Cir. 2008)). Again, *BB&T* is not a stock ownership case. It involved a "lease in/lease out", commonly called a LILO, the facts of which are not even marginally related to stock ownership in a foreign sales corporation. As with the Tax Court's numerous citations to

sale/leaseback cases, the Commissioner offers a LILO left shoe for a Code-created FSC right foot.

Echoing the Tax Court's citation to *Lyon v. United States*, the Commissioner resurrects this case for the argument that the taxpayer won because the Supreme Court held the taxpayer to have undertaken "substantial risk." (455 U.S. 561, 577). But, to repeat a point made in the Mazzeis' Opening Brief, the "real and substantial risk" in *Lyon* was limited to the facts – whether the taxpayer was entitled to a tax *deduction*, which is not the issue in *Mazzei.* Deductions are not an issue here, and for FSCs, tax benefits were the congressional goal.

Undeterred, the Commissioner cites *Swift Dodge*, in which a car dealer leased vehicles under an open-ended agreement where the lessee was required, at lease termination, to pay any amount by which the depreciated value of the car exceeded its wholesale value. The Ninth Circuit quickly recognized this was typical of a conditional sales contract, and held that since the lessor bore no continuing risk, it was not entitled to an investment credit. All of which is good law, but what does it have to do with FSC stock ownership? (*Swift Dodge v. Comm'r*, 692 F.2d 651 (9th Cir. 1982)).

1. Risk is Inherent in the Statutory Construct

It is especially odd that the Commissioner pursues a risk/benefit argument, because in *Benenson I* the First Circuit rejected exactly that argument: namely,

that the Roth IRAs therein assumed insufficient risk: "To the extent that risk was required, it came from reliance on the DISC … Without DISC commissions, the Benensons' Roth IRAs would have received no dividends." (*Benenson v.Comm'r,* 887 F.3d 511, 522 (1st Cir. 2018) ("Benenson 1")). While the *Mazzei* stock "ownership" rationale had not yet been crafted by the Tax Court when *Benenson* was decided, the issue of risk was very much at play—and the First Circuit held for the taxpayers, because risk was already part of the statutory "scheme."

The Second Circuit echoed this finding: "Although the Commissioner argued that the IRAs had assumed no investment risk … the degree to which the Roth IRAs would benefit from owning JC Holding depended on the success of Summa's export subsidiaries." (*Benenson v. Comm'r,* 910 F.3d 690, 700 (2d Cir. 2018) ("Benenson 2")).

Far from distinguishing those cases, the Tax Court and the Commissioner's arguments fall squarely within them; deference is appropriate.

Having lost their best argument already, the Tax Court and the Commissioner embark upon an odd metaphoric mix: "The majority found that the Roth IRAs were exposed to no real risk beyond the negligible purchase price, whereas taxpayers were … exposed to … business risk … in their export business." (Br.20). Huh? The FSC stock carried no risk, so therefore taxpayers were deemed to own it because their *company* had business risk? Appellants

respectfully submit that the First and Second Circuits said it better: if risk is even relevant herein, it can be found in the reliance the Roth-IRA shareholders had to place on the DISC or FSC *and* its U.S. supplier.

2. "Benefit" Was—Again—Congressionally Expected

The fallacious risk argument, in turn, leads to the Commissioner's companion fumble: the degree to which the FSC shareholders could expect to benefit. The Commissioner asserts that the value of the FSC lies in its benefit to the related supplier, not the Roth IRAs. But herein, the supplier was an LLC that could derive no tax benefits from FSC commissions (BNA Portfolio Portfolio, Export Tax Incentives 934-2d, at A-60-61; see b. on p. 61). And because Congress structured FSCs to provide value to an exporter, a shared FSC had no independent market value on the general securities market. In terms of burdens and benefits, the only parties herein that could realistically benefit from FSC ownership were the Roth IRAs.

Further, in raising this issue the Commissioner's argument is sliced by both sides of the same coin: while asserting that the Roth IRAs "could not have expected any benefits as an objective matter" (Br.53), the very next sentence complains about a "30,000% return on their $500 payment" (found on Br. 54, and

fondly repeated on Br. 17 & 59).[5] Rather than explain the dichotomy between 'worthless' and 'excessive', the Commissioner instead pivots on Br.54 to the issue of "economic reality," a dubious argument when construing a Congressional structure that was riddled with so many economic non-realities it could not survive attack by the WTO.

The return on investment, of which the Commissioner complains, pales in comparison to *Summa*. In Mazzei, the taxpayers' Roth-IRAs received FSC dividends of "more than $530,000" which the Commissioner characterizes as a "scheme." (Br.16, et al.). But if the amount of dividends is to be the basis on which this case is decided, it is worth noting that in *Summa* and *Benenson,* the taxpayers' Roth IRAs received over $6.477 *million* – to which the First Circuit opined: "Some may call the Benensons' transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not." (*Benenson 1, supra,* 887 F.3d at 523).

It is also worth noting that the *Benenson* Roth IRAs each paid $1,500 for their DISC shares from which these large dividends were received – yielding a

[5] One struggles in vain to duplicate the suspect math in this conclusion: $500 multiplied by 30,000 would be *fifteen million!* Conversely, 30,000% of $500 would be $150,000. Neither result makes any sense.

return twelve times (12,000%??) larger than in *Mazzei* (*Benenson 1, supra*, at 515). *Yet three circuits sustained the transaction.*

If, as the Commissioner seems to believe, shock value is relevant in resolving this appeal, the calm composure of three circuits in the face of significant Roth IRA investment returns is worth considering.

Risk-benefit analyses may be useful in determining ownership of openly-traded stock. It is also useful in deciding whether a car dealer really had a depreciable interest in a leased car. But to cite such authority in an effort to prove who *really* owned stock in a closely held FSC is a weak argument.

B. <u>The Stock Purchase Price Was Commercially Reasonable</u>

The Commissioner complains of the $500 stock purchase price, which he and the Tax Court improperly reduce to just $1. But the $500 price was consistent with commercial standards then-prevalent for purchase of FSC stock. BNA Portfolio, Export Tax Incentives 934 2d, at 58-60, provided that "Participating exporters paid only for actual start-up costs (on the order of $500 per participant) and annual maintenance costs." (*See also* BNA Portfolio 6360, at 554). This is precisely what Mazzeis paid for 100 shares. In contrast, the Benenson Roth IRAs each paid $1,500 for 1,500 shares. (*Benenson 1, supra*, 887 F.3d at 515). Mazzeis thus paid $5 per share while the Benensons each paid $1 per share – and, to repeat

a point worth reflection, the Benenson transaction, yielding $6.7 million, was upheld by three Circuits.

The Tax Court's finding of a $1 purchase price defies logic, yet the Commissioner repeats it on Br.20 and 59 as received truth. Both the Court and Commissioner derive that figure from a shareholders' agreement which recognized that the FSC stock value was dependent on Angelo Mazzei's creative presence, and fixed the price at $1 *only* if the stock were sold to someone else. That was an honest recognition of Angelo's importance to the export business and the FSC. It also recognized that, as structured by Congress, an FSC was dependent on a U.S. supplier, and related ownership of stock (even by a Roth IRA) incentivized foreign sales of U.S. goods. A Small FSC, such as that in *Mazzei,* was especially dependent on the personal skills of someone like Angelo.

The Commissioner complains that the parties "expected" large commission payments would be made to the FSC from export sales (Br.15-16). But that entirely hinged on the continuing success of Mazzei products in the international marketplace, foreign competition, foreign copying of Mazzei products, and Angelo Mazzei's ability to meet these challenges (ER169:8-10). His presence was critically important to stock value – a fact completely consistent with the Congressional goal of stimulating foreign commerce through a tax incentive to persons actually involved in marketing U.S. goods. The very thing complained of

by the Commissioner was built into the FSC by the Code and Regulations. (Treas. Reg. § 1.922-2(b)(1)(iii)).

Oddly, the Commissioner simultaneously argues that the stock was worthless (Br.63) while complaining that the purchase price was too cheap (Br.59). Both assertions cannot be right. Veering between those extremes, he claims that the stock was "essentially worthless" because there was "no chance" that commission payments would be made, absent related party control (Br.63) – in other words, the stock was worthless to anyone but someone interested in the welfare of Mazzei foreign sales. *But there is the rub:* that is exactly what FSCs were designed to accomplish.

Perhaps inadvertently, the Commissioner thus stumbles into a syllogism that exposes a fallacy:

Major premise: The FSC stock is no different from any other stock on the open market.

Minor premise: An open market buyer could not rely on the FSC's profitability.

Therefore: The FSC stock is "essentially worthless."

To achieve that result, the Commissioner must ignore the whole purpose behind FSCs, and employ case law drawn from open market stock sales. Appellants respectfully offer an alternative: the FSC stock purchase was unique

under the Code, and the price was commercially reasonable, meeting the practice standards at the time.

C. Mazzeis Did Not Exercise Impermissible Control

The "crucial question is whether the taxpayer retains sufficient power and control over the *assigned property* or over *receipt of income* … to treat him as the recipient of the income for tax purposes." (Br.51, emph. suppl.) So declares the Commissioner, citing a 1948 case and forgetting that the issue in *Mazzei* is not income tax but excise tax, and that in *Mazzei,* an income tax deficiency was not even asserted by the IRS.[6]

Undeterred by arguing out of the wrong Chapter of the Internal Revenue Code—about the wrong kind of tax—the Commissioner next reaches for *Commissioner v. Sunnen,* 333 U.S. 591, 604 (1948), which held that where a husband assigned certain patent rights to his wife, it was simply a reallocation of income within a family, and did not shift tax liability. From this factual non-sequitur, the Commissioner extracts a statement that sounds good until one reflects on what it is attached to. Assignment of patent rights between husband and wife is, like the sales/leaseback cases relied on so heavily by the Tax Court, a citation as devoid of landing space herein as Noah's crow.

[6] This fact is highlighted by the Commissioner's urging that the case be remanded to clarify that the deficiency is in *excise,* not income, tax. t

A more recent cite, *Commissioner v. Banks*, is also distinguishable factually – unless one can draw some filmy link between FSC stock and civil rights litigants who recovered judgement and paid, but did not report as income, their attorney fees. (543 U.S. 426, 434 (2005)). To be sure, attribution of income is therein held to relate to "dominion over the income-generating asset." (*Banks*, *supra,* at 434). But there are two significant objections. *First*, "A DISC … does not generate the income which it enters on its books." (*Addison v. Comm'r*, 90 T.C. 1207, 1221 (1988)). Since DISCs and FSCs are treated the same for excise tax purposes, the same applies to a FSC.

Second, the Commissioner urges that "the FSC generated dividends – that is income – which, in form, were paid to the Roth IRAs." (Br.60). Put more correctly, the FSC *paid* dividends – from funds it received in exchange for being required to do nothing. As the Dissent in Mazzei put it: "the majority calls the FSC an income-producing asset … That's wrong. Injector Co. was the operating business that actually generated income … All the FSC did was accept payments for nothing and distribute a large portion of them as dividends." (ER 169:90). And before one decides that such an arrangement is a sham (as the factually irrelevant *Block*, *Polowniak,* and *Repetto* cases would have done)[7], one must recall that the

[7] *Block Developers v. Comm'r,* T.C. Memo 2017-142; *Polowniak v. Comm'r,* T.C. Memo 2016-31; *Repetto v. Comm'r,* T.C. Memo 2012-168.

FSC's loose requirements were created by Congress to promote the public policy of encouraging exports.

The Commissioner argues on Br.60 that if the dividends were not income to the FSC, they could not have been investment income to the Roth IRAs. That argument is transparently incorrect: the source of any corporation's dividend payments – whether corporate savings or unearned largesse – would not alter the fact that they are income in the hands of the stockholder. And they were investment income to the Roth IRAs, whatever one wants to call them in the FSC's hands.

But even if, as the Commissioner urges, one concludes that the FSC had income, what about the control issue for which he cites both *Sunnen* and *Banks?* He argues that retention of FSC control by Mazzei Co. requires reattribution of FSC shares to the Mazzeis. What he is really demanding is that when an exporting company established an FSC, as Congress intended, control of the FSC must then be surrendered to …

… come to think of it, *to whom?* To some disinterested third party, whose management decisions might not produce the foreign trade advantages the exporter sought, and which Congress intended? To someone other than his wife – to avoid the fate of Mr. Sunnen? If one ponders the question for a moment, reality sets in: an FSC, over which the exporter had no control, would utterly fail to deliver the

incentives Congress intended. In raising the "control" argument, the Commissioner tries to apply generalizations (such as those found in *Banks*) to a transaction inherently different from the cases he cites.[8] And he misses the fact that a special-purpose corporation such as an FSC has unique characteristics that render his citations factually inapposite.

As a result, his brief often conflicts with the FSC as structured in the Code. On Br.53, for example, "the Roth IRAs did not own the FSC in substance because (i) taxpayers' business retained complete control over whether commission payments would ever be paid to, or retained by, the FSC…" *But that is exactly how FSCs were structured:* because they were intended to motivate foreign sales of U.S. goods, the exporting company was allowed to retain control over income flow – not inappropriate where Congress did not require an FSC to actually *do* anything in exchange for payment.

FSCs were – as the World Trade Organization would later assert – an intentional subsidy to U.S. exporters. Relaxed restrictions on control, including broad latitude on commission payments, came with the FSC package. To cite cases such as *Robino* for the proposition that control somehow dooms stock

[8] The Dissent, below, put it well: The majority "relies only on *Commissioner v. Banks*" to "mistakenly" call the FSC "an income-generating asset." (ER169:89). Having done so, it "applies constructive ownership tests from a series of sale-leaseback cases." (ER169:90).

ownership in the Mazzei FSCs, is to swing too broad a net, and in the wrong direction.

In *Robino,* the misuse of pension trusts by multiple parties, each trust purchasing an option in the other trust's interest, was a ruse the Ninth Circuit rejected, and for good reason. (*Robino, Inc. Pension Trust v. Comm'r,* 894 F.2d 342 (9th Cir. 1990)). But nowhere in *Robino* does one find the unique structure of the FSC, in which stock ownership by a related party was an essential element. If the Commissioner is correct, then no FSC could ever have been owned by the company with which it contracted. That would, *et posse ad esse,* have doomed the program Congress created.

A mistaken assumption can be exposed by insisting that it be carried to its logical conclusion. If, as the Commissioner argues, the Mazzei Roth IRAs could not have owned the FSC stock because there was too much control by the Mazzeis, then the Mazzeis themselves could not have owned it either. Nor could a Mazzei-owned corporation. Go that far, and the Commissioner could have destroyed FSCs before the WTO ever got around to doing so.

To ensure that its shared-FSCs complied in all respects with Federal law, Western Growers Association promulgated copious documents including an Operations Procedures Memorandum, Commission Agreement, Services Agreement, Management Agreement, Shareholders' Agreement, and Compliance

Guide. (ER169:12-14). Petitioners followed these instructions, and managed the FSC in accordance with the Code and Regulations: "the Commissioner concedes that the Mazzeis observed these formalities." (ER169:93).

Nonetheless, the Commissioner complains about WGA's "marketing materials" advising prospective FSC users of what the law allowed (Br.55-56), and he suggests that these unmask a nefarious purpose. But Petitioners followed the Code and Regulations, and, consistent with the purposes of an FSC, its stock was held by entities in which the taxpayers had an interest. That they "controlled every aspect of the transaction" (Br.62) was an inherent reality in any FSC transaction—yet the Commissioner calls this an improper retention of control.

Boiled down, the only real complaint here is that the Roth IRAs provided too attractive an investment vehicle. *And this element was known to Congress – which never changed it.*

The Commissioner admits his real objection: "they [the Mazzeis] intended to transfer huge sums of money into the FSC for the benefit of their Roth IRAs." (Br.62). One searches in vain in ER169:63-65 for the word "huge", suggesting a mischaracterization of the Tax Court's Report, but in ER169:64 the Court states its objection to the transaction: an "independent holder of the FSC stock" could not "expect to receive anything. Petitioners' transactions pay only if the same parties

control both Injector Co. and the Roth IRAs…" In other words, the Tax Court complains that both the FSC and its stockholders shared common control.

Of course they did! That was precisely the way FSCs were structured. Retention of control over FSC ownership, contracts, and cash flow, together with a tax benefit, was intentional – it gave a U.S. exporter assistance in foreign commerce. Did the system work as intended? Yes – so well that the World Trade Organization found it to be a prohibited export subsidy under GATT, after which Congress enacted the FSC Repeal and Extraterritorial Exclusion Act of 2000, repealing sections 921 through 927 of the Code. (Pub. L. No. 106-519, 114 Stat. 2423 (Nov. 15, 2000)).

In the FSC regime (not "scheme"), Congress created something to assist exporters, in which retention of transactional control was an essential element. The very characteristic of which the Tax Court and Commissioner complain was the essence of the FSC program.

Rather than adopting the Commissioner's argument that Congress has knowingly stood down, preferring to let the Commissioner fight this (losing) war (Br.34-35), Mazzeis prefer the Ninth Circuit's holding in *Taproot*, which accepts Congressional inaction as evidence of Congressional intent. Congress knew and allowed the transactions twice allowed by Judge Nims on the Tax Court, and upheld by the First, Second, and Sixth Circuits.

In summary, the "dominion and control" test, created by the Tax Court to reassign the stock in *Mazzei,* is, as the Dissent notes, "novel," and "relies only on *Commissioner v. Banks*" to "mistakenly" call the FSC "an income-generating asset." (ER169:89). Having done so, it "applies constructive ownership tests from a series of sale-leaseback cases" (ER169:90) into which the Court tries to "shoehorn" the *Mazzei* case (ER169:92). With respect, both the Tax Court and Commissioner are wrong.

D. <u>The Commissioner Misapplies "Economic Reality"</u>

This issue is embodied in much of the discussion *supra,* but needs brief recognition as a dedicated topic.

An FSC did not need to engage in the activities for which it was paid, and the decision to pay commissions, or to recoup commissions after payment, was left up to the exporter. (I.R.C. §§ 924(a), 921-927; Temp. Regs. § 1.925(a)-1T(a)(3)). The Commissioner seizes upon this unique structure to argue that there was no "economic reality" to the transaction (Br.16, 17, 54-55, 59. 61-64). *But that is the transaction Congress created.*

(Mis?) stating a "30,000% return on their $500 payment," (Br.54), the Commissioner argues that the Mazzei transaction somehow "lacked economic reality." This is essentially a "Yes, but…" argument: Yes, Mazzeis established an FSC. Yes, it complied in all respects with the Code and Regulations. (ER169:93).

Yes, the FSC issued stock – but the stock was held by related entities that enjoyed too great a tax break, so *this can't be real.*

To this end, the Commissioner argues a "disconnect" between the "claimed value" and the "substantive value" of the stock – ignoring that the value computed at time of purchase followed then-prevalent commercial standards, and that the "substantive value" is supposedly the result of stock earnings. (Br.62). In truth, the entire future of the FSC depended on both Mazzei Co. and the presence of Angelo Mazzei (ER169:8-10).

In this context the Commissioner offers the bewildering conclusion that the stock was worthless because, just as the FSC structure allowed, it was subject to "related-party control," while simultaneously arguing it was extremely valuable because of the "economic reality of the stock's expected cash flows." (Br.63). That conclusion is based on one isolated point on the timeline, when the FSC's stock was acquired: "At that time, taxpayers' business was very profitable" (Br.16). But no consideration is given to economic uncertainties, or to Angelo's health—and he had just survived a fight with cancer.

The Commissioner claims that the Tax Court decision was not based on the conclusion the tax result was too good to be true (Br.63). But that is exactly his argument, cloaked as "economic reality." Under this ploy, he seeks to justify ripping the FSC stock out of Appellants' Roth IRAs. He is not supported by the

cases he cites: neither *Robino* or *Solberger,* nor the Tax Court's many sale/leaseback citations, involve the unique characteristics of an FSC or its issuance of stock.

FINAL THOUGHTS

This case must be viewed as what it is – a Commissioner upset because taxpayers managed to make two entities work together too well, and a Tax Court thrice reversed, finally concluding that the way around prior reversals was to sham stock ownership in an entity whose stock was never intended to be an open market commodity. The case law cited by both the Commissioner and the Court is misapplied.

WHEREFORE, the Mazzeis again respectfully ask this Court to reverse that portion of the Opinion and Decision of the United States Tax Court finding them liable for excise taxes.

Respectfully submitted,

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